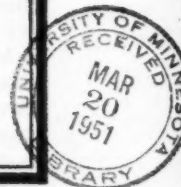




1951

Monthly Letter on Economic Conditions Government Finance



New York, March, 1951

General Business Conditions

THE rush to buy, which made January an extraordinarily active month in trade, has abated somewhat since the price freeze was ordered January 26, although by any standard demand holds at a high level. In recent weeks gains in department store sales over a year ago have averaged 15 per cent, which is large except as compared with January's 28 per cent. The slackening in wholesale trade has been more pronounced. A chief reason is the effects of the freeze itself, which in some lines paralyzed business because it placed retail price ceilings too low relative to replacement costs. But this may not be the full explanation. Buyers all along the line have been anticipating requirements, increasing commitments, and enlarging inventories. Business men know, however, that buying may be overdone, and with the risk—however small—that some change in the international situation might make inventories look less desirable, it is not surprising that notes of caution are being uttered.

A slackening of this kind occurred last fall. If it recurs now the general situation will be the

better for it. The buying rush has had beneficial effects in that it stimulated production and brought unemployed resources into use. The country has on hand greater reserves of finished goods—of new durable goods particularly—and the ability of the economy to function efficiently if a period of deprivation comes has thus been strengthened. On the other hand, the pressures to buy have become disproportionate to the increase in supplies, and they have contributed to the inflationary spiral. What is now needed is restraint in spending and in stocking up, and more saving.

Price Expectations Still Bullish

That moderation of the boom psychology would go to the other extreme and bring about any significant recession seems unlikely, in view of the outlook for high industrial production and employment, a rising national income, and increasing government purchases as the year goes on. Price expectations in the main continue bullish. Mr. Johnston and Mr. DiSalle, who bear the chief responsibility for price stabilization, are frank in saying that they do not expect the rise to be halted for some months. Their reasons are apparent. Most agricultural products are exempt from control by reason of the statutory prohibition against ceilings below parity or the pre-Korean level, whichever is higher. Formulas for wage stabilization will allow further increases in wage rates, hence in costs, and in wage incomes. Finally, replacement costs, where they are too high in relation to ceilings prices at the next stage of distribution, will have to be passed on, lifting the ceilings. The Office of Price Stabilization recognized that this relief was necessary to keep business going, and it is provided by changes in the price regulations announced February 27, permitting retailers to add normal markups to the cost of goods purchased. In all these ways prices may advance.

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Most industries have large backlogs of unfilled orders, to which the January buying contributed heavily. Manufacturers of consumers' durable goods face materials shortages which will limit their operations, but their prospect for at least the first half of the year is better than many people realize. The automobile companies have been ordered to reduce their use of steel in passenger cars in the second quarter by 20 per cent below the average of the first two quarters of 1950. The Chrysler Corporation, however, will be entitled to an allowance to compensate for its 100-day strike last year. Even with this restriction and similar limitations on the use of copper and other metals, reliable estimates suggest that the automobile companies will be able to approach closely, although perhaps not equal, their production of 3,100,000 passenger cars in the first half of 1950.

Deferment of more drastic curtailment until the second half year, when arms production will be larger, tends to minimize the degree of "conversion unemployment" to be expected in the consumers' durables. Meanwhile the heavy industries are turning in remarkable figures. New orders for machine tools in December and January were four times the pre-Korean level, and unfilled orders equal seventeen months' shipments at the January rate. Building activity shows persistent vitality. Despite the credit restrictions, contract awards in January were 43 per cent and in the first half of February 36 per cent above a year ago, and new housing starts in January, while seasonally below December, were the highest on record for the month. Non-durable goods industries are under pressure to supply demand, which is augmented by government orders.

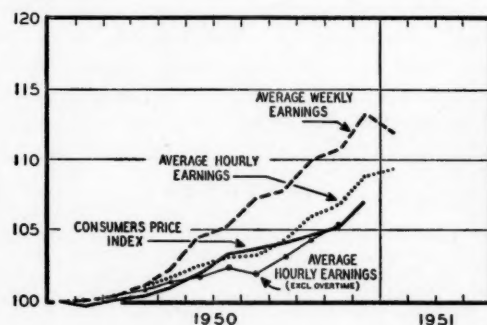
The Wage Stabilization Formula

To an ever increasing extent the economic situation is revolving around Washington and being governed by decisions made in Washington. The problems of price and wage stabilization are uppermost, and as they develop the desire of each group affected by controls, ceilings or taxes to protect itself becomes evident. On February 16 the Wage Stabilization Board, subject to the approval of the Economic Stabilization Administrator, adopted a regulation limiting the permissible increase in straight time wage rates to 10 per cent above the level of January 15, 1950. The three labor members of the nine-man board, however, voted against the regulation and walked out, refusing to participate further in the work of the board.

After an eleven-day delay Mr. Johnston, the Administrator, signed the order but requested the board to modify it immediately in several respects. He specifically authorized the exemption from the 10 per cent limitation of increases in wage rates called for by escalator clauses tied in with the cost of living, in contracts effective before January 25. He requested a similar exception for provisions for annual wage increases in recognition of increased productivity, the so-called "improvement factor". He would also exclude health, welfare and pension plans from the 10 per cent maximum, and he requested the board to draft regulations providing for adjustment of hardships and inequities. All elements of the program are to be reviewed and reexamined not later than June 30 of this year.

Present Relation of Wages and Living Costs

The accompanying chart sets forth as of latest available dates the relation of wage rates in the manufacturing industries to the cost of living, calculated on the base period January, 1950, according to Bureau of Labor Statistics data. It shows that in November average straight time wage rates (excluding overtime premiums) were almost exactly in line with the cost of living. Later figures unfortunately are not available. To reach the allowable 10 per cent increase, a rise of nearly 5 per cent above the average November rates could take place, even without the good-sized loopholes asked by Mr. Johnston.



Average Wages in Manufacturing Industries and Cost of Living (Consumers' Price Index), Jan. 1950=100. Source: Bureau of Labor Statistics.

The chart also shows that the straight time rate understates factory workers' income, because earnings are made up not only of straight time rates but of overtime and other premiums. Another line in the chart shows actual hourly earnings, averaging overtime premiums over the work week. This line rose above the cost of living line in September and has maintained a good lead since. Finally, average weekly earn-

ings are given. Reflecting the influence of longer hours, they show a steady gain in real purchasing power.

The margin between contractual straight time rates and actual hourly earnings is almost certain to widen as the familiar "upgrading" and shifting of jobs, which inevitably develop in tight labor markets, makes its appearance. Thus the rise in hourly earnings under the formula can obviously exceed 10 per cent, and by a substantial margin if all the loopholes asked by Mr. Johnston are provided. What the cost of living may be by June 30—the date when revision is promised—remains to be seen. But the probability indicated by the respective lines on the chart is that factory workers under the formula will enjoy a rise of real income on an hourly basis—in other words in real earnings per unit of work—even without the further increase in working hours which in many industries is desirable.

Inflationary Effects

If this is the outcome the influence of the wage formula will not be to establish equity, but to create inequity. The purchasing power of factory workers will keep ahead of the cost of living increase, and the added buying power (unless nullified by greater taxes and saving) will come into the markets as enlarged demand for goods. In a time of declining supplies of consumer goods an increase in the real purchasing power of any group must be at the expense of other elements of the population. This is the pertinent point as to the equity of the formula. As to its inflationary effect, further wage increases unless offset by greater productivity will raise industrial costs, and the increased money income also will exert its upward push on the price level.

The position of the farmer under the stabilization program is equally privileged, by reason of the statutory exemptions already referred to. As higher wages force up industrial costs, and the increases work their way into the prices farmers pay, the farm parity price—the level at which ceilings are permitted—will rise. This in turn will interact on the cost of living, and so around the circle. The farm parity price computation itself includes a substantial percentage of farm commodities such as foods and purchased feed; this permits the parity index in effect to spiral within itself when farm prices are rising, even though manufactured goods prices remain unchanged.

On behalf of increases in compensation for special groups, it will be argued that incentives

to work and production must be preserved. But if the decision of the stabilization agencies is that preservation of incentives makes it necessary to accept inflationary mechanisms, the need to adopt offsetting counter-inflationary policies becomes all the more urgent. This brings the discussion back to the point at which it inevitably arrives, namely, the need for taxes of the kind and magnitude that will drain off excess spending power, and of coordinated fiscal and monetary policies to restrain inflationary pressures, as discussed in the subsequent articles in this Letter.

Essentials of Inflation Control

In this brief record of one month's developments can be seen the basic reasons why the program to curb inflation is working badly. With respect to price and wage controls, the weaknesses in part are inherent. A freeze in either prices or wages destroys the flexibility which in normal times is relied upon to keep the economy in balance. It freezes inequities and impracticable relationships and for that reason checks production and trade, unless relief is given. But relief or exceptions in any direction raise demands for compensating relief or exceptions elsewhere. Meanwhile powerful political groups use their power to protect themselves against sacrifice, at the expense of requiring greater sacrifice from others. To exert pressure for this purpose, labor union leaders walked out of the Wage Stabilization Board, resigned from all positions in the defense effort, and denounced Mr. C. E. Wilson, whose offense seems to be that as Defense Mobilization Administrator he is determined to get his job done effectively and with regard to the general interest above special interests. Fortunately Mr. Wilson continues to enjoy the confidence of the country.

The United States Treasury seeks exemption from any increase in borrowing costs that might be caused by desirable anti-inflationary policies. The Congressional hearings on taxation become a cockpit of conflicting representations by groups intent on protecting themselves, culminating in the proposal of a labor union economist that exemptions from the personal income tax be raised to \$2,500 for a married couple; this of course would free more billions of dollars of income from taxation and leave it to exert its inflationary powers in the markets. While this goes on the rise in incomes and spending power continues, and well designed anti-inflationary measures such as Regulations W and X, limiting consumer and housing credit respectively, fail to have the anticipated effects because people can pay cash

or meet larger down payments without the expected difficulty.

This list could be extended. The evil is that if the politically powerful groups obtain exceptions the inflationary pressures will not be contained, and all will suffer. The problem of leadership, if the objective of establishing an effective price and wage stabilization in the next few months is to be reached, is to get people to think and act in terms of the general interest, and resolutely to place the welfare of the whole country ahead of group interests in the hard decisions now in the making.

Price Pegs for Bonds

The manifest reluctance of the Federal Reserve System to support the government securities market on a fixed scale, as desired by the Administration, led the President on February 26 to call a conference of high government officials to discuss credit policy. Attending the conference were Defense Mobilization Director Wilson, Treasury and Federal Reserve officials, Chairman McDonald of the Securities and Exchange Commission, and legal and economic advisers attached to the President's office. In the course of the conference the President read a memorandum which, while laying great stress on the need for stability in the government security market, opened the Administration's credit policy for reexamination, and probed for solutions to the conflict between maintaining stability in the government security market and applying restraints upon private lending and investment.

The present controversy over pegging the bond market had its immediate origins in the Secretary of the Treasury's "Financial Mobilization" speech of January 18. Pressures subsequently brought to bear to force the Federal Reserve into line have provoked a widespread discussion, in the press and on the floors of Congress. This has broadened the public understanding of the issues involved and at the same time evidenced growing fears that policies now being followed would lead to further shrinkage in the buying power of the dollar.

The President's Memorandum

"I have been much concerned," the President's memorandum stated, "with the problem of reconciling two objectives":

First, the need to maintain stability in the Government security market and full confidence in the public credit of the United States, and second, the need to restrain private credit expansion at this time. How to reconcile these two objectives is an important facet of the complex problem of controlling inflation during a defense emergency which requires the full use of our economic resources.

It would be relatively simple to restrain private credit if that were our only objective, or to maintain stability in the Government security market if that were our only objective. But in the current situation, both objectives must be achieved within the framework of a complete and consistent economic program.

We must maintain a stable market for the very large financing operations of the Government. At the same time, we must maintain flexible methods of dealing with private credit in order to fight inflation. We must impose restraints upon nonessential private lending and investment. At the same time, we must maintain the lending and credit facilities which are necessary to expand the industrial base for a constant build-up of our total economic strength.

The President entrusted to the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Director of Defense Mobilization, and the Chairman of the Council of Economic Advisers the task of studying ways and means of reconciling the two objectives, expressing the hope that in the meantime "no attempt will be made to change the interest rate pattern, so that stability in the Government security market will be maintained."

Direct Government Controls on Lending

Among other things, the President asked the group to consider specifically measures:

(1) to limit private lending through voluntary actions by private groups, through Government-sponsored voluntary actions such as was done in a narrow field by the Capital Issues Committee of World War I, and through direct Government controls; and (2) to provide the Federal Reserve System with powers to impose additional reserve requirements on banks.

Under the first heading he referred to efforts already under way by the American Bankers Association, the Investment Bankers Association, and the Life Insurance Association, and the possible establishment of a committee such as the Capital Issues Committee of World War I but operating in a broader area.

On the proposal to set up "direct government controls" over lending, the memorandum stated:

Furthermore, I should like you to consider the necessity and feasibility of using the powers provided in the Emergency Banking Act of 1933 to curtail lending by member banks of the Federal Reserve System. These powers are vested in the Secretary of the Treasury subject to my approval . . . The program could be extended to institutions other than member banks, if desired, by using the powers provided by the Trading with the Enemy Act.

Neither set of powers mentioned has been specifically repealed. The banking emergency of 1933 never has been declared at an end, and the national emergency powers in the 1917 legislation were invoked in the Presidential proclamation issued last December. The suggestion that these extraordinary powers are applicable to the present situation is, to say the least, a little startling.

Under the heading of more powers for the Federal Reserve over bank reserve requirements, the President recalled previous recommendations he had made to Congress. In January, 1948, he recommended that Congress give "close study" to proposals previously made by the Federal Reserve Board for a scheme of "special" reserve requirements by which banks would be effectively compelled to buy and hold stipulated amounts of low-yielding government securities. In April, 1948, the Board laid this aside in favor of a "supplemental" reserve requirement which received the President's endorsement and was enacted into law in August for a temporary period which expired June 30, 1949.

Whose Responsibility?

One broad question that has been raised in the controversy is the propriety of having the Executive bring pressure to bear on an independent agency, the Federal Reserve, in carrying out responsibilities given to it by the Congress. Walter Lippman, writing in the New York Herald-Tribune on March 1, crystallized the issue:

Mr. Truman does not, it appears, recognize that the Federal Reserve is an independent establishment with duties which are laid upon it by the law, duties which it cannot, or at least should not, abandon because he asks the board to do that. . . .

If the President believes the emergency is such that the Federal Reserve system should cease to be independent and should become, as Senator Glass put it, a bureau of the Treasury, then he should accomplish that by asking Congress to amend the law and not by pressure from the White House.

Senator Douglas, speaking on February 22 from the floor of the Senate, described the situation with his usual vigor and forthrightness:

Over the shoulder of the Federal Reserve System has stood the Treasury, making threatening passes and gestures and from time to time, cracking its whip . . . Whenever the Federal Reserve or its Open Market Committee, which carries out the purchases, has been reluctant to go along on this unlimited program of bond and security purchases, the Treasury has resorted to a strategy of mixed cajolery and threats . . .

The Reserve Board has been told that it should cooperate, that it should stand by the President and not rock the boat. It has been told that if the price of Government bonds falls or the interest rate rises, the Reserve Board will be held responsible . . . It is intimated that if the Reserve Board is recalcitrant the Reserve System will be nationalized and all independence will be taken away . . . Under this pressure the Federal Reserve System has gone along. But the real responsibility has been that of the Treasury. The Treasury has pulled the strings, and the Federal Reserve has danced to its music.

A Doubtful Premise

Apart from the matter of responsibility, and where it should lie, question may be raised as to the major premise in the President's memo-

randum—namely that "full confidence in the public credit of the United States" requires "stability in the Government security market," the latter being taken to mean a scale of minimum price pegs acceptable to the Treasury and maintained by the Federal Reserve. This premise deserves careful examination. Is it true that confidence in the public credit depends on pegging operations carried out by the Federal Reserve? Is it true that U. S. bonds can't be sold except in a rigged market, that buyers won't come forward if there is any risk of price decline?

In the money and capital markets securities are bought and sold every day of the week. Their prices fluctuate under varying pressures of supply and demand, searching and finding equilibrium at the point where the number of buyers will absorb the available supply. In the security markets generally rigging the markets is frowned upon and is indeed contrary to public policy expressed in the Securities and Exchange Act. New bond issues are floated continuously by corporations, States and municipalities and soon find their natural level.

Yet the idea has become prevalent—and is implied in the President's memorandum—that United States Government bonds, the world's prime security, must have artificial market supports provided for the life of the obligation so that the price is virtually guaranteed.

This is a relatively new idea. For most of the history of the United States there was no Federal Reserve System to render such support. Up until World War II the System did not attempt rigid price support, though when the market was upset it sometimes bought or sold to help maintain an "orderly market." In World War II the fixed pattern of rates first became a fetish, partly by reason of the flood of deficit financing.

After the war the Reserve System undertook to get away from this fixed pattern of rates and the obligation to insure the buyer of government securities against loss. One reason they did so was that they found a pattern of pegged rates was a bonanza for the speculator. But the principal reason was that the obligation to support the market clashed with the responsibilities of the System for credit control. They found themselves compelled by buying securities to pour money into the market at times when they were trying to make money less available and resist inflation.

Considerable progress in freeing the market from rigid control was made in short-term securities. The present controversy arises in connection with longer-term securities. Just at a time when the Reserve System is faced with a

serious inflation, which by all the experience of the past calls for a firm money policy, the System is asked to return to maintaining set price pegs for bonds which are above the prices at which an equilibrium of buyer and seller can be maintained, and therefore would require the large outpouring of funds at a time when just the opposite policy is necessary.

Differentials in Rates

Postwar experience refutes the theory that the money and capital markets are insensitive to differentials in interest rates, even small ones. Some of this experience is found within the government securities market itself. While long-term bonds have been religiously held above par, to the benefit of sellers, short-term securities, on occasion, have been allowed to decline in price and to improve in yield. The demand for Treasury bills, entirely outside the banks, has shown an amazing growth since the artificial $\frac{1}{2}$ per cent rate was abandoned in 1947.

The immediate source of embarrassment to the Federal Reserve is the excess of supply over demand of long-term $2\frac{1}{2}$ per cent bonds, largely held by insurance companies, pension funds, and other savings institutions. Life insurance companies today are selling such bonds, at premium prices offered by the Federal Reserve, and putting the money into mortgages and corporate bonds for an improvement in net rate of return of $\frac{1}{4}$ or $\frac{1}{2}$ per cent. This they feel they need to prevent a further rise in insurance costs to their many millions of policyholders. Savings banks, on a smaller scale, do the same to make possible better rates on savings accounts. Many pension funds have turned to common stocks, for a portion of their investments, to hasten the building of their reserves. The individual citizen, in many cases, is also shifting his investments for a better return.

It would be no reflection on the credit of the United States if the Federal Reserve System should allow marketable government securities to decline in price, and if the Treasury should improve the rates it offers on new securities to meet the market situation and make them competitively attractive and saleable. This is the free market economics — achieving the desired sales volume and distribution by proper pricing.

Where Pegs Lead

If the Treasury is unwilling to offer what the investor considers a fair return, where do we go from there? The President's memorandum points the way. We must install compulsions to buy — in the first instance on the Federal Reserve Banks, later perhaps on banks or others. But

this may not be enough — there may have to be detailed restrictions on private lending and borrowing, using powers written into emergency legislation in 1917 and 1933.

The dangers in this whole course of policy are recorded in a statement recently submitted to the Congressional Joint Committee on the Economic Report by a group of over 400 economists, from all over the country and representing many shades of viewpoint. Stating the need for an overbalanced cash budget and general restriction of the total supply of credit, involving some rise of interest rates, they went on to point out the alternatives:

If general inflationary pressure is not removed by fiscal and credit measures, we face two alternatives: (1) Continued price inflation, or (2) a harness of direct controls over the entire economy which, even if successful in holding down prices and wages for a while, would build up a huge inflationary potential in the form of idle cash balances, Government bonds, and other additions to liquidity. Such accumulated savings would undermine the effectiveness of direct controls and produce open inflation when the direct controls are lifted. Everyone remembers vividly the sharp inflation of 1946-48 when the wartime accumulation of liquid assets went to work on prices after the removal of direct price and wage controls.

Either of these alternatives is extremely dangerous. A prolonged decline in the purchasing power of the dollar would undermine the very foundations of our society, and an ever-spreading system of direct controls could jeopardize our system of free enterprise and free collective bargaining. For these reasons we urge that fiscal and credit policies constitute our primary defense against inflation.

Lines of Solution

The morass of regimentation is avoidable and by essentially simple measures. The Federal budget is still running in surplus and it is unlikely that borrowings required later in the year will put any impossible test on the savings capacity of the nation. The first task is to reestablish an equilibrium in the longer-term market, drawing away from artificial price supports, and thus discourage selling by existing holders and encourage buying with new funds. Once equilibrium is reestablished, once the fears bred by the artificiality of the present market are taken away, there will be plenty of buyers for United States government bonds. They are, after all, the best bonds in the world.

A second logical step is to accompany this action by using more fully the good will and cooperation of the people involved. In connection with the President's reference to voluntary means of credit restriction, Mr. James E. Shelton of Los Angeles, president of the American Bankers Association, wired the President:

On February 9, on behalf of the American Bankers Association, I communicated to the Board of Governors

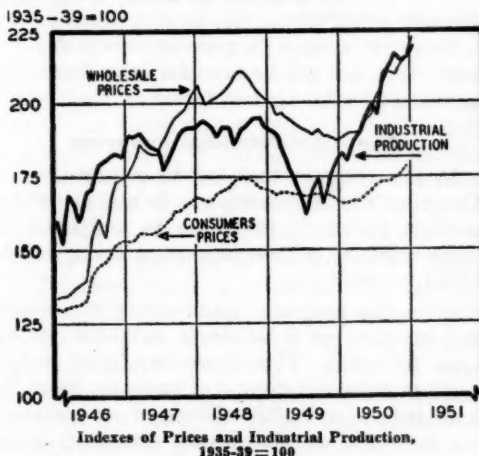
of the Federal Reserve System our willingness as an association to proceed under the guidance of the Board in carrying out the voluntary credit control program authorized in Section 708 of the Defense Production Act of 1950.

On December 14, Chairman McCabe of the Federal Reserve Board discussed this program at our National Credit Conference in Chicago. Since then, commercial bankers, insurance men, and investment bankers have formulated a set of principles for noninflationary lending by banks, insurance companies, and investment firms. This Association is ready to proceed to make this program of voluntary credit control effective through committees set up for that purpose, as soon as the Board of Governors of the Federal Reserve System is able to promulgate it.

You mentioned first the voluntary credit control program as a means of attaining the objective of noninflationary lending. I desire to assure you of our willingness to cooperate. You will remember that in 1948 the American Bankers Association carried out a voluntary credit control program within its own industry and with good results. We were appreciative of your endorsement of that effort. We believe that all possible avenues of approach to the solution of this problem should be taken along voluntary lines before further laws and regulations are employed in this field.

Bank Credit and Inflation

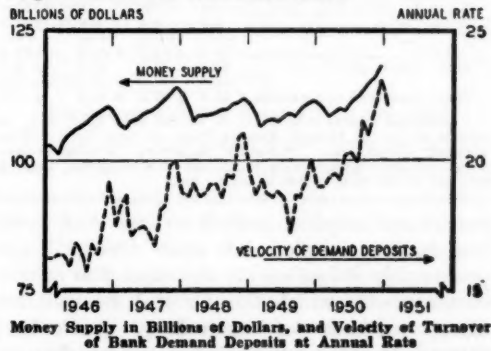
In the current debate about bank credit and its relation to inflation, the real facts in the case are often overlooked or exaggerated. In the following diagrams and table we present available data bearing on this question.



Taking first the diagram on prices and production, it will be seen that both have risen sharply over the past year, but that this rise has been partly a recovery from the slump which occurred during 1949. If we compare the indexes of production and prices at the end of last year with those at the end of 1948, the increases have been much more moderate, amounting to 12 per cent in the case of in-

dustrial production, 8 per cent in wholesale prices, and 4 per cent in consumers' prices.

Turning next to the diagram on money supply and velocity of demand deposits, the interesting thing is that the volume of money, which is so commonly blamed as the inflationary factor, was at the end of last year up only 6 per cent compared with the end of 1948, or the end of 1949. At the same time, the velocity of deposits, or the rate at which people were actually drawing upon their bank checking accounts, was up 10 per cent from December 1948 and 15 per cent from December 1949.



In other words, the major part of the increase in business volume and prices of the past two years has been financed, not as much by new additions to money, as by more active use of existing money.

The table which follows records these comparisons, and gives figures on business inventories, as reported by the Department of Commerce, together with figures on the breakdown of bank loans and investments, as shown by the weekly reporting member banks. While the data are given for December of each of the three years 1948-50, here again we emphasize the 1948 to 1950 changes as the more significant by reason of the influence of the 1949 business slump upon comparisons with that year.

Looking at the inventory figures, about which there has been so much discussion, it will be seen that despite the sharp rise during the past year—much of it a recovery from the 1949 liquidation—the holdings by manufacturers have increased over the level of two years ago by only about 5 per cent. Stocks of wholesalers were up 14 per cent, retailers up 12 per cent, and the overall total was up 8 per cent. These seem moderate increases indeed in view of the expansion in production as well as the rise in prices that have taken place over the period.

Examining next the changes in bank loans since 1948, it will be noted that the largest

Comparison of Prices, Production, Inventories, and Bank Credit

(Dollar Figures in Billions)

	Dec. 1948	Dec. 1949	Dec. 1950	% Change 1948-50
Wholesale prices (1935-39=100)	201.5	187.8	217.5	+ 7.9
Consum. prices (1935-39=100)	171.4	167.5	178.4	+ 4.1
Indus. product'n (1935-39=100)	192.0	179.0	216.0	+12.5
Money supply	\$111.6	\$111.2	\$118.2	+ 5.9
Velocity of demand deposits*	21.0	20.0	23.0	+ 9.5
Inventories				
Manufacturing	\$ 32.3	\$ 28.9	\$ 34.0	+ 5.3
Wholesale	9.5	9.0	10.8	+13.7
Retail	15.0	13.7	16.8	+12.0
Total	\$ 56.8	\$ 51.6	\$ 61.5	+ 8.8
Commercial bank credit**				
Business loans	\$ 15.6	\$ 13.9	\$ 17.8	+14.1
Security loans	2.0	2.2	2.5	+23.8
Real estate loans	4.1	4.3	5.8	+29.8
Loans to banks	.2	.4	.5	+150.0
Other loans	2.9	4.4	5.9	+51.3
Total†	\$ 25.6	\$ 24.9	\$ 31.6	+23.4
Total investments	\$ 37.3	\$ 42.5	\$ 40.3	+ 8.1
Total loans and investments	\$ 62.9	\$ 67.4	\$ 71.9	+14.3

* Estimated annual rate for U. S. outside New York City. As calculated by the Federal Reserve Bank of New York without seasonal adjustment. ** Weekly Reporting Member Banks. † Figures for various loan items are shown gross; they do not add to the total which is shown net.

percentage increase, aside from interbank loans, was in the so-called "all other" loans. These presumably reflect mainly the expansion in consumer credit, which the Federal Reserve has direct methods of controlling, particularly through its Regulation W. The next sharpest increase was in real estate loans, over which the Federal Reserve has control through Regulation X. The next increase in order of magnitude was in security loans, and here again the Federal Reserve has control by means of its power to raise margin requirements.

In actual business loans, the increase of 14 per cent was not at all of sweeping or abnormal proportions in view of the increase in prices and volume of business. It should be remembered that bank borrowing is the marginal money which business needs when demands exceed their own resources.

In the face of these facts, real question may be raised as to whether recent discussions of credit and inflation have not been getting things out of perspective. The fact is that people in business like everybody else are on notice that the United States is launched on a gigantic defense effort, and that business activity is moving upward by leaps and bounds. Any prudent person in this situation is going to try to anticipate his requirements. Inventories and receivables naturally are going to be higher.

Unquestionably, it is a time when these tendencies have to be watched and restrained to try to keep speculation and unnecessary use of credit from accentuating inflationary tendencies. But it is a time also when bank credit has an

essential role to perform in carrying out the defense effort.

Federal Tax Proposals

With the submission by President Truman of his annual budget message in January, followed up early last month by his request for new taxes, Congress now faces the two-fold task of passing upon his spending and taxing proposals.

In his budget message the President estimated expenditures for the fiscal year 1952 at \$71½ billion. To balance the budget and keep defense spending on a pay-as-we-go basis, as everyone agrees it should be, the President has asked for \$16½ billion in new taxes — \$10 billion immediately and \$6½ billion later in the year.

In passing upon these proposals Congress's first job is to trim down non-essential items. Despite the President's insistence that he has presented a "tight" budget, there is still far too much evidence of the kind of open-handed spending, both global and domestic, that has swelled our peacetime budgets. Many projects of doubtful merit are appearing — or reappearing — in the guise of national defense. This impression of padding is fortified by studies by Senator Byrd and others indicating room for cutting some \$6 to \$9 billion out of the budget without harm to defense or other essential government functions.

However, even with genuine efforts at economy, there will still be need for more taxes. The question is, what kind of taxes?

The Administration Program

In the program that has been presented to Congress, the Administration is asking for immediate boosts of \$4 billion in individual income taxes, \$3 billion corporation taxes, and \$3 billion excise taxes.

How this program would affect the federal tax structure as a whole is indicated by the table following. This shows estimated budget receipts by major groups of taxes for fiscal '52, both before and after allowance for proposed tax increases, compared with estimated or actual receipts for selected prior years.

The striking fact brought out by the table is the preponderant extent to which our federal tax system has come to depend upon direct taxes on income. Taken together, such taxes would, under the proposed program for 1952, constitute 83 per cent of total net budget receipts, compared with 78 per cent in 1950, 81 per cent in 1945, and 50 per cent in 1939.

Comparison of U. S. Government Budget Receipts, Fiscal Years 1939-1952

(In Billions of Dollars)			Rev.	Est.	Pro-
	1939	1945	1950	1951	posed
Direct taxes on individuals	1.4	19.8	18.1	22.8	26.8
Direct taxes on corporations	1.3	16.4	10.9	18.6	20.0
Excise taxes	1.8	5.9	7.6	8.2	8.2
Employment taxes	0.7	1.8	2.9	3.8	4.7
Employment taxes proposed					0.3
Customs	0.3	0.4	0.4	0.6	0.6
Misc. receipts	0.2	3.5	1.4	1.8	1.8
Gross receipts	5.7	47.8	41.3	49.8	61.9
Deduct:					
Old-age insurance trust fund	0.5	1.3	2.1	3.0	3.3
Old-age insurance trust fund proposed					0.3
Refund of receipts	0.1	1.7	2.2	2.3	2.7
Net budget receipts	5.1	44.8	37.0	44.5	55.1

What Tax Principles Should Govern?

In determining where new taxes should fall, it is important to consider what tax principles should govern.

In the first place, taxes, to yield the sums wanted, must be broadly based. As the President has said, "all economic groups must pay much higher taxes." At the same time, as the President's Council of Economic Advisers recently pointed out in discussing individual income taxes, —

by far the largest part of the additional revenue must come from the middle and low tax brackets. These are the brackets in which the great bulk of the income is located. Of the net income on all taxable returns, 86 per cent of the amount remaining after federal income taxes is estimated to be received by taxpayers with net incomes of less than \$10,000. To hold down consumption, which is vital to the control of inflation, the bulk of consumers must be affected directly by tax increases.

In other words, we can't get the money, or control inflation, just by "soaking the rich." They simply don't have the money. The fact is that even if the Government took the drastic and destructive course of taxing away *all* income over \$25,000 a year the yield would be less than \$1 billion a year above present taxes. This would make hardly a dent in the expected deficit.

Nor can we get most of the money by "soaking" the corporations, popular as that may be. There is a limit to what corporations can pay without loss of incentive, fostering of waste and extravagance, and mounting pressure to pass the taxes along in higher prices. When a business must pay taxes of 55 per cent of its net earnings, plus 85 per cent of so-called "excess profits", as now proposed, it is getting beyond that limit.

The second principle is that taxes should be fair as between the different elements in the community. People must feel that they are being treated equitably in order to put themselves wholeheartedly into the defense effort and be willing to pay their full share of the cost. At present there is a very large amount of the

national income that escapes both the corporate tax and the individual income tax. To eliminate these "free riders", and distribute taxes more broadly, we need additional types of taxes. Yet the Administration proposes getting \$7 billion out of the \$10 billion new taxes requested by hitting the same old groups.

Thirdly, we need taxes that are collectible. The higher a tax rate is jacked up, the greater the incentive to tax avoidance. Hence the more broadly taxes are spread by diversification, the more completely they become collectible. They don't hit so heavily at any one point.

Finally, we need taxes that are anti-inflationary — that do not bear down on production and saving, but discourage consumption. In short, we need taxes on spending.

Excise and Sales Taxes Fill the Bill

Excise and sales taxes meet these specifications. Although few persons would regard such taxes, taken by themselves, as an equitable method of taxation, they should perform a more significant role than they are doing at present.

The fact is that even before Korea our tax structure was often criticized as too dependent upon direct taxes on individual and corporate incomes, with their susceptibility to severe slump in times of depression. The need today for raising large amounts of additional revenue, and for discouraging spending, has strengthened the arguments for enlarging the scope of excise taxes, or for introducing a federal sales tax. Such taxes would accomplish the objective of broadening the tax base, spreading the load, reducing tax avoidance, and taxing spending rather than production and saving.

The validity of the objection usually offered that these taxes are "regressive", i.e., fall with heavier weight on the lower income groups, is considerably modified by two factors. One is the steeply progressive character of the federal tax system as a whole. The other is that it has been the lower income groups, by and large, that have benefitted most from the rise in incomes generally over the past ten years.

Also, excise and sales taxes generally exempt certain basic necessities, which constitute a relatively large proportion of the budgets of the lower income family units. As for expenditures in which there is a larger element of choice, the individual can spend or not spend, as he wishes, and he is taxed only on what he spends and not on what he saves.

Summary

In summary, the job of keeping defense spending on a pay-as-we-go basis boils down mainly to two things:

1. Cutting federal expenditures so that the overall magnitude of the tax problem becomes less formidable.

2. Finding the right kinds of additional taxes.

This last means turning first to taxes that will (a) restore the balance in our tax structure, now topheavy with direct taxes on corporate and individual incomes, (b) distribute the tax load more broadly, reaching incomes that now escape direct tax, and (c) curb spending rather than production and saving.

The answer is greater reliance upon indirect taxes—excise and sales taxes. After that, it may still be necessary to squeeze some more out of corporate and individual income taxes. But it is important to recognize that this means taking some serious risks. Already these taxes have been pushed past the danger point, and every additional turn of the screw makes new inroads on enterprise and productivity.

1950 Corporate Earnings

Corporate reports published for the year 1950 reflect the vigorous business recovery that occurred during the first six months, followed by the tremendous upsurge of business and consumer buying after Korea. Benefitting both from capacity operation of the enlarged and more efficient plant facilities installed since the war, and from the resiliency of selling prices under the impact of the almost universal scramble for goods, most companies were able to absorb rising wage rates and material costs, as well as higher federal income tax rates plus the excess profits tax, and still show sharp gains in net income to the highest level ever reached.

For the group of 2,213 corporations thus far reporting, combined net income in 1950 totaled approximately \$7.9 billion after income and excess profits taxes, compared with \$6.0 billion in 1949, an increase of 32 per cent. Despite this favorable showing for the group as a whole, one out of every four reporting companies in 1950 showed a decline in profits compared with 1949. Our preliminary summary by major business groups is given in the accompanying table.

For the 1,041 companies in the manufacturing industries, the combined net income showed an increase in 1949-50 of 35 per cent. Individual group changes varied widely, ranging from increases of over 80 per cent, particularly in those lines which had slumped in 1948-49, down to very moderate gains, or even decreases for others as a result of rising costs and taxes.

Because of the price rise last year, the dollar value of sales increased much more than the physical volume. The price rise tended to inflate the reported net earnings, through the non-

Preliminary Summary of Net Income of Leading Corporations for the Years 1949 and 1950

(In Thousands of Dollars)

No. of Cos.	Industrial Groups	Reported Net Income After Taxes 1949	1950	Per Cent Change
17	Baking	\$ 57,036	\$ 57,391	+ 1
18	Meat packing	31,963	52,177	+63
17	Sugar	23,107	33,136	+43
67	Other food products	194,901	222,999	+14
10	Distilling	111,488	139,728	+25
15	Tobacco products	94,560	94,140	- 0
32	Cotton goods	50,514	72,446	+43
52	Other textile products	122,754	179,875	+47
24	Clothing and apparel	12,644	18,708	+48
24	Shoes, leather products	21,696	30,447	+40
14	Tires, rubber products	85,674	149,943	+75
26	Lumber, furn., wood prod.	36,401	65,891	+81
47	Pulp and paper prod.	117,078	170,360	+46
13	Printing and publishing	20,244	22,710	+12
50	Chemical products	504,824	699,699	+39
18	Drugs, soap, cosmetics	74,368	119,086	+60
15	Paint and varnish	21,176	32,156	+52
22	Petroleum products	267,185	330,922	+24
19	Cement	42,947	44,553	+ 4
7	Glass products	47,962	59,957	+25
23	Other stone, clay prod.	41,392	64,519	+56
37	Iron and steel	539,199	745,511	+38
10	Agricultural implements	155,281	170,189	+10
43	Bldg., heat., plum., eq.	85,387	57,910	-31
44	Elec. equip., radio & tv.	168,228	251,148	+49
31	Hardware and tools	21,799	31,338	+46
13	Household appliances	19,975	26,031	+30
93	Machinery	75,331	90,432	+20
17	Office equipment	43,797	54,084	+23
78	Other metal products	192,750	300,997	+56
54	Autos and parts	134,167	175,168	+31
12	Railway equipment	24,345	11,632	-32
74	Misc. manufacturing	67,698	78,278	+16
1,041	Total manufacturing	3,456,001	4,669,006	+35
16	Coal mining*	25,172	34,503	+37
9	Metal mining*	14,041	23,827	+69
14	Oil and gas*	29,972	23,269	- 6
7	Other mining, quarry*	9,978	12,101	+21
45	Total mining, quarrying	80,063	98,700	+23
12	Chain stores—food	50,478	52,733	+ 4
35	Chain stores—var., etc.	113,019	120,090	+ 6
33	Department & specialty	93,919	101,214	+ 8
37	Wholesale & misc.	43,702	55,723	+28
117	Total trade	301,118	329,765	+10
132	Class 1 railroads	433,153	305,500	-34
14	Traction & bus	D-972	D-567	—
8	Air transport	10,169	16,603	+63
28	Misc. transportation	13,954	12,564	-10
182	Total transportation	461,309	334,100	-31
121	Elec. power, gas, etc.	531,029	596,920	+12
54	Telephone & telegraph	251,622	385,288	+53
175	Total public utilities	782,651	982,208	+26
14	Amusements	17,833	23,812	+34
25	Restaurant & hotel	7,223	7,068	- 2
19	Other business services	31,801	35,979	+13
11	Construction	12,379	12,956	+ 5
69	Total amuse., services	69,241	79,815	+15
293	Commercial banks	460,951	495,420	+ 7
20	Fire & casualty insur.†	103,134	73,270	-29
139	Investment companies‡	169,042	232,922	+38
43	Sales finance companies	76,734	96,145	+25
84	Real estate companies	12,336	16,367	+37
584	Total banks & finance	822,197	914,624	+11
2,213	Grand total	\$5,972,580	\$7,908,218	+32

* Net income is reported before depletion charges in some cases. † Figures represent in most cases operating earnings only, excluding gains or losses on investments. ‡ Increases or decreases of over 100% not computed. D—Deficit.

recurring profit from selling out low-cost inventory, despite efforts to eliminate its effect by accounting devices such as the "last-in, first-out" method of inventory valuation, or the use of inventory reserves. As the advancing valuation of inventories and receivables tied up more cash, many businesses found themselves under the necessity of increasing their bank loans notwithstanding their bigger reported profits.

Another effect of the rising price level as it applies to plant facilities has been to throw out of balance the depreciation charges against earnings based upon original costs of buildings and equipment, which are far below present-day replacement costs. In recognition of this discrepancy, a number of companies have set aside from surplus special reserves for the high-cost replacement of capital assets, as well as for inventory valuation, even though such reserves are not allowable deductions from income in the computation of taxes payable.

Among the major divisions of business, the sharpest gain was an increase of 81 per cent shown by transportation. This was due largely to the rebound in railroad earnings, reflecting both the high level of production and distribution generally, and the fact that earnings in 1949 were depressed by major strikes in the coal and steel industries, bad weather and other causes.

A majority of the systems supplying electric light and power, natural and manufactured gas, telephone and telegraph, and other public utility services continued their long-term growth in gross revenues and in net earnings last year.

Earnings of the retail and wholesale trade concerns increased somewhat less than other major groups. Profit margins were held down by the accompanying rise in costs of goods purchased, operating expenses, and taxes.

Our final summary of 1950 earnings, in the April issue of this Letter, will include a great many additional corporate reports due to be published during March and will show, by major industrial groups, the average profit margins on sales and rates of return on net assets.

Manufacturers' Use of Funds

Some indication of the shifts among the principal items of assets and liabilities may be seen from the following composite balance sheet of 150 manufacturing corporations, each having sales or total assets over \$5 million. The group had combined sales of approximately \$13.5 billion in 1950, and total assets of over \$10 billion at the year-end.

It will be seen that the largest absorptions of funds in 1950 were \$415 million for increased

Composite Balance Sheet of 150 Manufacturing Companies
with Sales or Total Assets over \$5 Million
(In Millions of Dollars)

Assets	December 31—			
	1940	1945	1949	1950
Cash	\$ 524	\$ 797	\$ 908	\$ 981
Government securities†	47	746	876	1,117
Receivables, net	480	812	937	1,352
Inventories*	1,147	1,705	2,612	2,938
Total current assets	2,198	4,060	5,333	6,389
Land, plant & equipment	3,556	4,012	6,011	6,416
Less depreciation	1,688	2,480	3,003	3,177
Net property	1,868	1,532	3,008	3,239
Other assets	383	343	416	433
Total assets	4,449	5,935	8,757	10,055
Liabilities & Capital				
Notes payable	57	186	132	195
Accts. pay., accruals, etc.*	302	552	667	929
Reserve for taxes†	213	708	583	1,046
Total current liab.	572	1,441	1,382	2,170
Bonds, notes, etc.	586	437	1,352	1,328
Reserves	71	139	178	192
Capital and surplus	3,220	3,918	5,845	6,365
Total	4,449	5,935	8,757	10,055
Working capital	1,626	2,619	3,951	4,213
Ratios:				
Current assets to cur. liab.	3.8	2.8	3.9	2.9
Equity capital to total liab.	2.8	2.1	2.1	1.8

† Before deducting tax notes offset against taxes payable.

* Includes advances on government contracts.

receivables and \$321 million for increased inventories. In 1949 both of these items had been substantially liquidated. It is interesting that receivables increased more than inventories. Both reflect increased prices and larger business volume as well as forward buying policies.

There was an increase of \$241 million in 1950 in government securities, including tax notes held against the large increase in taxes payable, while cash was up slightly. Property account was increased by \$405 million gross, and by \$231 million net after deducting the depreciation reserve. The total absorption of funds was about \$1,300 million.

Of this total, \$788 million or more than half was obtained by increasing current indebtedness on notes and accounts, accruals, taxes, etc. The sum of \$520 million was obtained from the increase in capital and surplus, representing mainly the retention of the year's earnings, only 49 per cent of which was paid out in dividends.

While the ratio of current assets to current liabilities of 2.9 to 1 was somewhat lower than at the year-end 1949, the net working capital of \$4,213 million was up \$262 for the year, and was more than 2½ times that of ten years ago. Of course not all companies are in the strong position indicated by this limited sampling of the statements of the larger organizations. Nevertheless, this showing of liquidity is reassuring in view of the heavy demands industry faces in 1951 for meeting military and civilian requirements, which in many instances will call for expanding plant capacity still further.

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FROM the industrial point of view, Japan is divided into three parts. They are East, Central and West, with their respective centers at Tokyo, Nagoya and Osaka. Branches of National City have long been established at Tokyo, Osaka and the important port city of Yokohama, south of Tokyo. Now, with the opening March 5th of Nagoya Branch, we are in a position to serve importers, exporters and other American businesses

having interests at this port for Central Japan, where 70% of the country's pottery and porcelain is produced, where woolen and cotton goods, looms and rolling stocks are major manufactures in a region noted for its high scale production.

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